

## APPENDIX

FOMC NOTES - PRF  
July 1-2, 1997

Mr. Chairman:

I will be referring to the three pages of color charts.

Since your last meeting, there has been a further unwinding of expectations for the Committee to raise rates. As you can see in the first panel, U.S. forward, three-month rates have shifted downward in recent weeks -- particularly following the data releases in early June.

Looking past all of the politics of European monetary union, German interest rate expectations have shown a very modest decline. While there are some indications that the German economy may pick up in the second half of the year, no one expects this to press on resources, nor to improve the German fiscal position appreciably, nor is there seen to be much -- if any -- risk of an increase in rates by the Bundesbank.

In Japan, as shown in the third panel, interest rate expectations have shifted up and down. Japanese forward rates were rising in May, significantly influenced by official pronouncements that the Japanese economy was stronger than the market thought and that the Bank of Japan would be raising rates sooner rather than later. But data releases in late May and early June did not support the heightened expectations created by the earlier open mouth operations and, once again, market participants perceived a postponement of any action by the Bank of Japan until closer to calendar-year end.

The market's first reaction to last week's release of the Bank of Japan's "Tankan" survey was to shift back to the stronger-sooner view. But looking past the headline index, and the exporters' continued strength, the soggy state of the non-manufacturing sectors suggested that the "self-sustaining forces of recovery" remain elusive.

Looking at this page as a whole, the narrow spreads between current and forward rates in all three markets are striking. In Germany the spread between current three-month deposit rates and those expected nine months forward is only 27 basis points, here in the United States it is 44 basis points, and in Japan: 62 basis points. Don and I frequently debate how to measure term premia in forward contracts: but, however measured, these are very tight.

Turning to the second page, even as Japanese interest rates declined a bit, shown in the top panel in the benchmark Japanese government bond, the yen has generally maintained its recent strength against a number of currencies, as you can see in the bottom panel.

The yen's continued strength, I think, is a function of the fears of the unhedged masses, resulting from the pain still lingering from the yen's sharp move in May.

For example, the two-year appreciation of the dollar against the yen induced Japanese exporters to lag their normal hedging of dollar receivables. But now, with a greater sense of two-way risk, the exporters are playing catch-up and, once again, their hedging activities weigh on the exchange market's consciousness.

Perhaps more importantly, I think we in the United States take too narrow a view of unhedged yen borrowings. By referring to this type of exposure as the "yen carry trade" we compartmentalize it as something limited to the sophisticated, leveraged strategies of hedge funds.

However, in the Asia-Pacific economies, borrowing from Japanese banks is routine and unremarkable. While good data on unhedged yen liabilities is hard to come by, anecdotally it seems to be worthy of note.

One Asian central banker suggested a rather powerful analogy to me, by observing that the Japanese banks were doing in reverse sequence exactly what the U.S. banks did in the 1980s. U.S. banks first over-extended themselves lending to developing economies and, followed this up in the mid- and late 80s by overindulging in the U.S. real estate market. Japanese banks first over-extended themselves in Japanese real-estate lending in the late 1980's and have spent the last several years aggressively lending to (what we now call) emerging market economies, such as Thailand. Ignoring the obvious supervisory issues, this view helps me better understand why I am hearing as

much today about unhedged yen liabilities, with dollar-yen trading around 114, as I did two years ago when dollar-yen was trading below 100.

Turning to the third page of charts, the unwinding of expectations for any near-term rate increase by the Committee gave another shot of adrenaline to the rally in financial assets: here are but a few examples.

In the first panel, you can again see the impact of the data releases in early June, leading to the sharp narrowing of the spread between the Committee's Fed Funds target and the yield on the two-year note. Following the non-farm payroll and retail sales figures -- and reflecting, in part, the tight technical conditions in the short-end of the yield curve which I will come back to in a moment -- this spread was squeezed down to 50 basis points, before widening out a bit in the last few days.

In the second panel, as a proxy for the general rally in emerging market debt, spreads over comparable Treasuries of Latin American, stripped Brady bonds are shown. I think it is significant, if understandable, that these spreads narrowed so noticeably on the fact of the Committee's decision to leave rates unchanged at your May meeting, suggesting the importance of risk premia tied to the level of U.S. rates.

In the third panel, various equity indexes are graphed, re-indexed to April 15th for comparison. You can see that the spring rally got going after the release of the first quarter ECI and then simmered down a bit. Looking back, I am a lot more comfortable with the fact that the market rallied in late April on muted price data than I am with the more recent leg of the rally, which took off on the suggestion of weaker economic activity, seen in the softer-than-feared employment report on June 6th and retail sales release on June 12th.

U.S. equity markets pretty much peaked out the next day, with the June 13th release of May PPI (which is not indicated on the chart).

Yesterday's Wall Street Journal story about the "liquidity premia" being paid for the bluest of the blue chip stocks, because they will be "easier to sell", strikes me a potential leading indicator of liquidity illusions.

Turning to domestic operations, required operating balances fell to just under 15 and half billion, breaking the previous low set in January of 15.75 billion, reflecting the continued growth of sweep accounts. However, overall, the Fed Funds market has behaved reasonably well -- with predictable exceptions, such as yesterday when the funds rate traded above 6 percent for much of the day with the conjunction of the quarter-end and the settlement of the two- and five-year Treasury auctions. In general, it still appears to me that the funds market is adjusting to the gradual decline in required reserve levels. However, Don and I have circulated to the Committee a paper, prepared by Board and Desk staff, on measures which could be taken to address funds market volatility should it develop.

Just before your last meeting, we concluded a 5.1 billion dollar par amount coupon pass and, in the last two weeks, we completed a second consecutive coupon pass, in three legs, for a total of 4.7 billion par amount.

In maintaining the current 50-50 balance between Treasury bills and coupon securities in the System Open Market Account, I have been trying to follow a pattern of alternating bill and coupon passes. However, the bill market has become extremely tight, as described in Section III.B. of the Desk's written inter-meeting report, principally as a consequence of the Treasury's notable decrease in bill issuance. Instead of purchasing bills, and further contracting the limited supply in the secondary market, I elected to purchase coupon securities.

Treasury's decreased issuance of bills is noteworthy as an example of external constraints on the management of the SOMA. Last September when the Committee discussed the optimal structure and management of the SOMA, some members expressed a preference for increasing bill holdings. While we still owe the Committee further work on the principles and alternative portfolio structures which could guide SOMA's management, I did undertake to increase the Desk's flexibility by arranging with the Treasury for them to treat SOMA as an "add-on" in bill auctions, just as they do in coupon auctions, so that amounts we roll over would not be deducted from the Treasury's total offerings to the public.

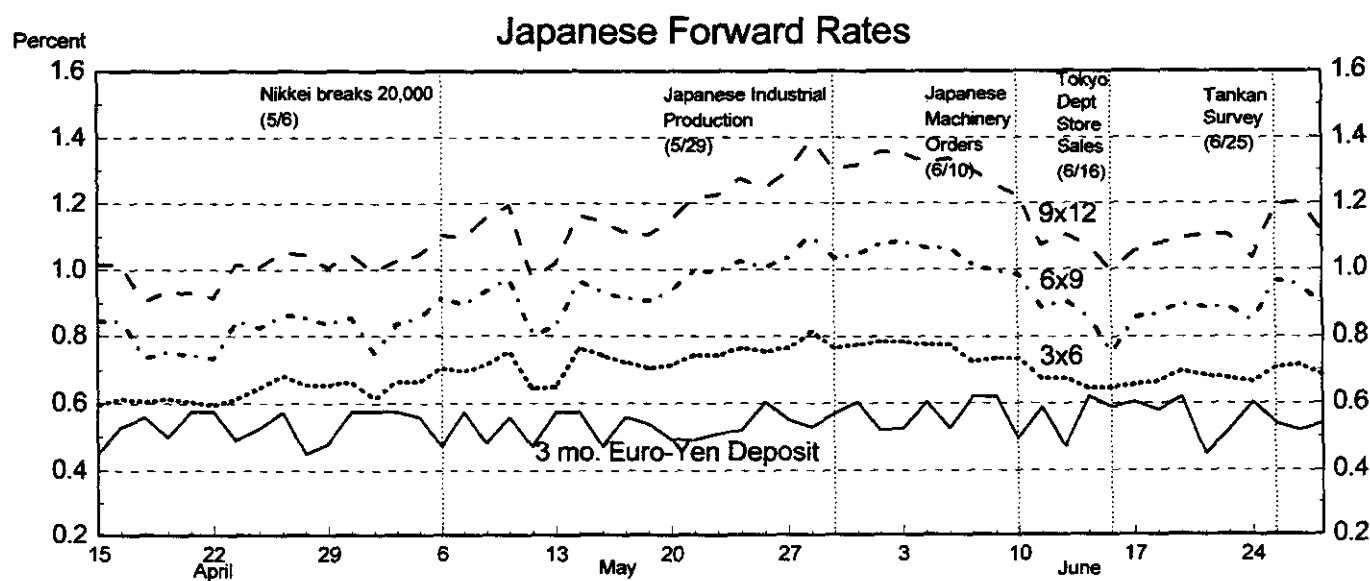
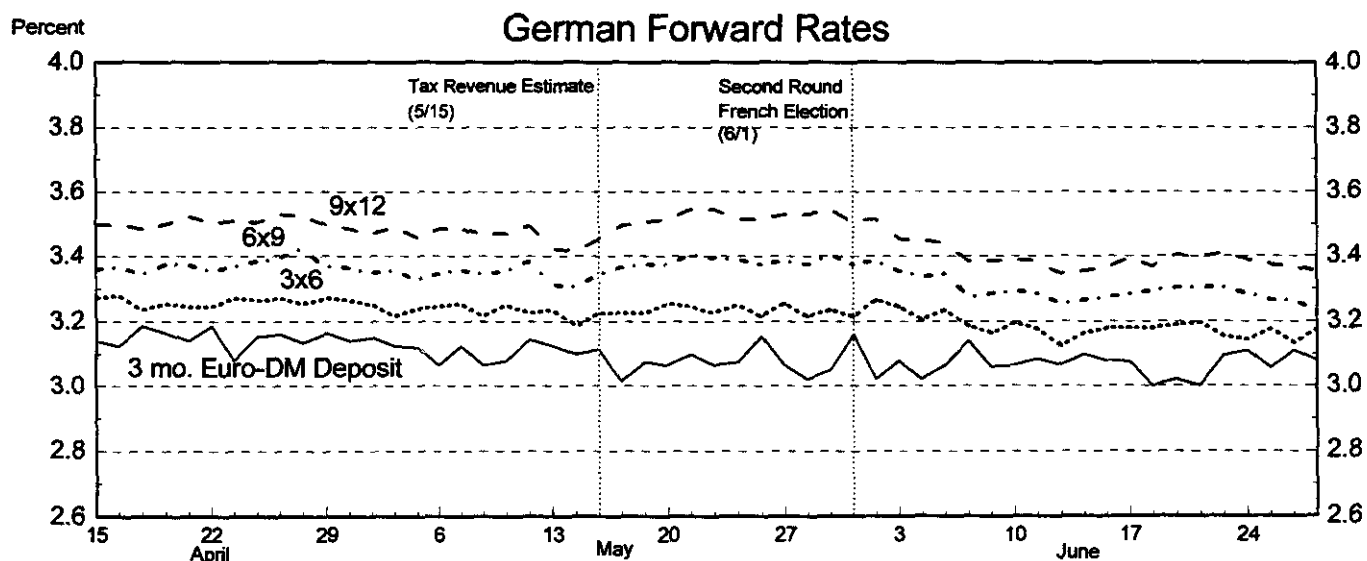
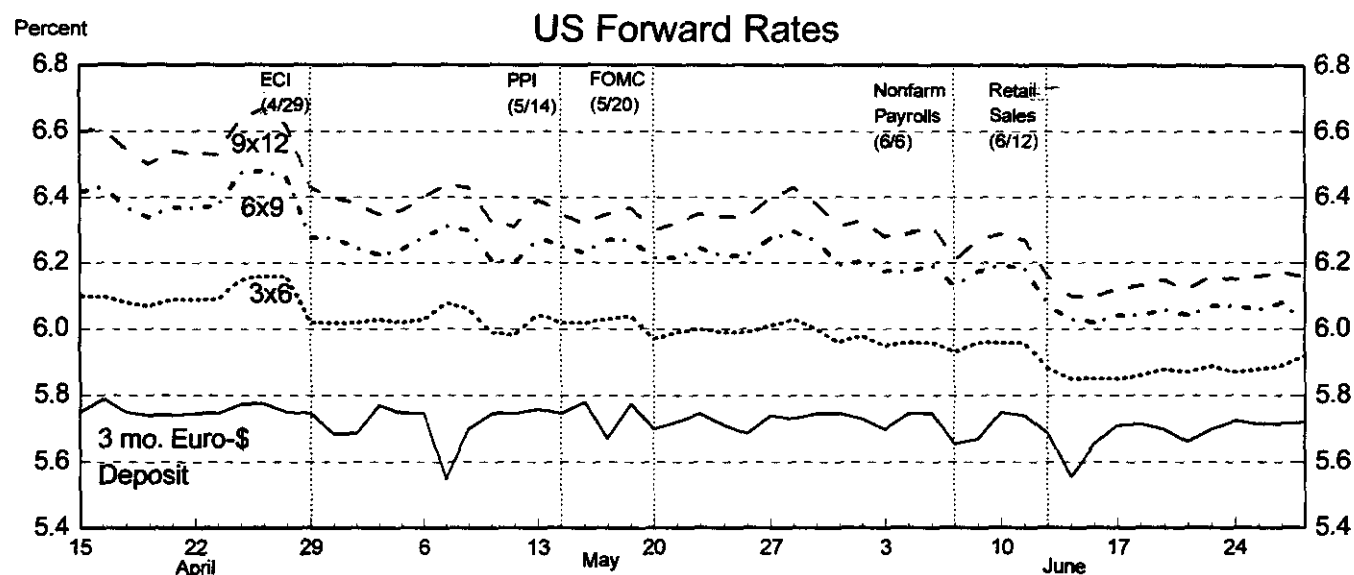
While formally the Treasury now treats our bill awards as an add-on, as a de facto matter, it still appears to me that their offerings to the public are affected by SOMA's rollovers and, thus, we continue to have an impact on bill supply in the market. I hope that, over time, the Treasury will become comfortable

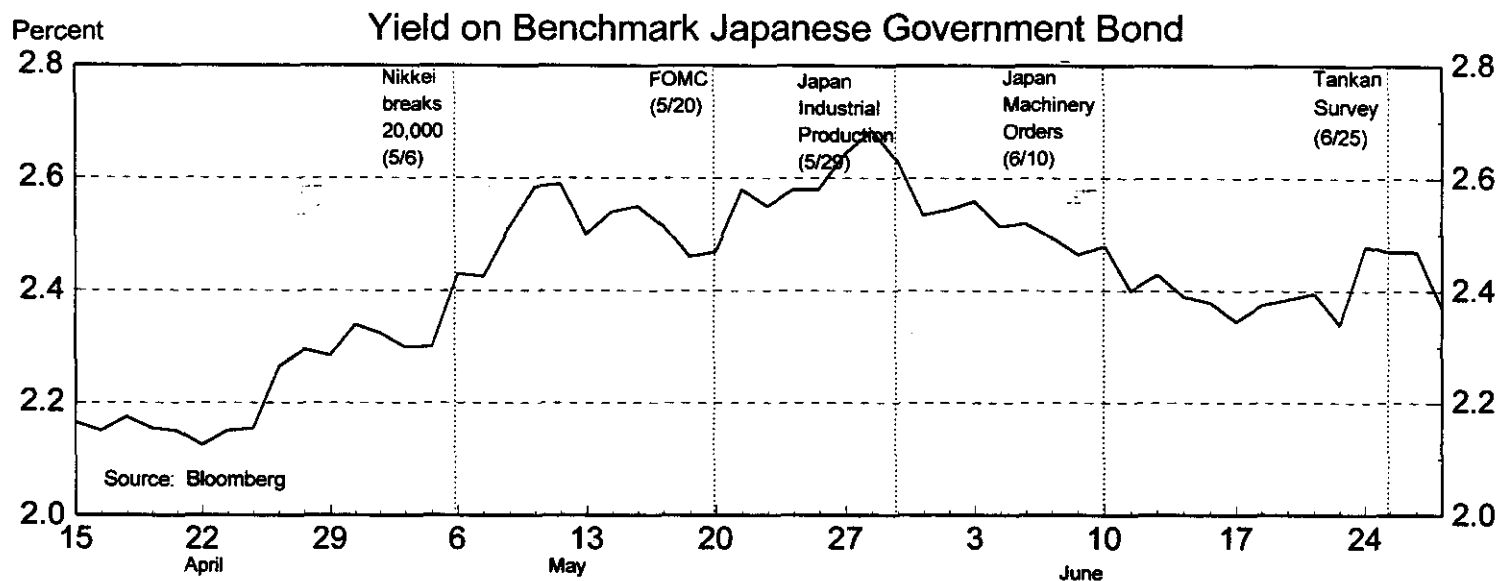
treating our bill holdings more flexibly and we will continue our dialogue. But, at least in the short run, unless we want to evaporate the bill market, I feel somewhat constrained from purchasing bills.

In general, I prefer the transparency of making SOMA purchase from the market and, thus, I have a preference not to purchase securities directly from foreign central banks when offered. More recently, I have also been conscious of the supply conditions in the bill market. However, on June 20th we did purchase just under 600 million dollars worth of bills from the Bank of Thailand, out of one billion they were seeking to sell. I was inspired to do this, in part, to avoid being seen selling a large quantity of bills in the market on the day the Thai finance ministry was changing hands. We also had a need to add reserves that day, which initially we thought would be around one billion, but we scaled back our purchase when our forecast need declined.

There were no foreign exchange intervention operations during the period.

Mr. Chairman, I will need the Committee's ratification of the Desk's domestic operations and I would be happy to answer any questions.





### Yen Appreciation Against Selected Currencies

